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No. 85-599

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT

UNITED STATES OF AMERICA, PETITIONER

v.

FREDERIC C. TURNER, ET UX., ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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TABLE OF AUTHORITIES

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In our petition, we contend that the decision below conflicts with recent decisions of the Fourth, Fifth and Sixth Circuits. See *Carolinas Farm & Power Equipment Dealers* v. *United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League* v. *United States*, 693 F.2d 525 (5th Cir. 1982); *Professional Insurance Agents* v. *Commissioner*, 726 F.2d 1097 (6th Cir. 1984). Each of those cases holds that the group insurance activities of a tax-exempt professional association constitute a "trade or business," and that the income derived from such activities is subject to unrelated business income tax. The thrust of respondent's brief (Br. in Opp. 12, 14) is that our contention "ignor[es] the unique facts of this case," facts that assertedly "present a stark contrast" to the facts of the three cases cited above. There is no merit to this assertion.

1. In each of the cases on which we rely, the tax-exempt organization "serve[d] as a middleman between

[its] member[s] * * * and commercial vendors of insurance" (*Louisiana Credit Union League*, 693 F.2d at 528). In its capacity as middleman, each association performed a variety of "promotional and administrative services" (*Professional Insurance Agents*, 726 F.2d at 1100). It selected the insurance underwriter; served as group policyholder; actively supported and officially endorsed the insurance program; distributed informational brochures to its members; answered members' telephone inquiries and otherwise marketed the program; processed its members' application forms and requests for changes in coverage; sent premium notices to its members, collected their premium checks, and forwarded the premiums to the underwriters; and generally "performed the day-to-day administrative tasks essential to the insurance * * * operations." *Louisiana Credit Union League*, 693 F.2d at 533; *Professional Insurance Agents*, 726 F.2d at 1099, 1100, 1102; *Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 168.

In each of the three cases, similarly, the association derived substantial revenues from its insurance activities. These revenues took the form of rebates from the insurance underwriters, computed either as a flat percentage of the members' gross premiums or as experience-rated refunds. *Professional Insurance Agents*, 726 F.2d at 1100-1101; *Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 168; *Louisiana Credit Union League*, 693 F.2d at 528. To the extent that the association retained these payments from the underwriters, rather than distributing those sums to its members, the court of appeals in each case held that "the insurance-related payments received by the [association] must be considered income in its hands." *Id.* at 531. See *Professional Insurance Agents*, 726 F.2d at 1100-1101 & n.1; *Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 168, 171.

In determining whether this insurance-related income was derived from a "trade or business," the court of appeals in each case adopted a "profit motive" test. In *Carolinas Farm & Power Equipment Dealers*, the Fourth Circuit held that "the proper inquiry is whether an

organization conducts an activity to earn a profit. If so, the activity is a trade or business" (699 F.2d at 169). The court observed that the association's insurance operations were "highly profitable," since it "consistently received far more in rebates than it expended in providing insurance services" (*id.* at 170). The court also found "strong evidence of profit motive" in the fact that the association chose to raise money by conducting activities —insurance activities—that were not "substantially related" to its tax-exempt purpose (*id.* at 171). As the Fourth Circuit put it (*ibid.*):

> If an activity which is not substantially related to a charitable purpose is conducted in a competitive profit-seeking manner and regularly earns significant profits, a heavy burden must be placed on the organization to prove [that] profit is not its motive. Certainly where, as here, an organization could easily rebate any profits to its members and thus * * * provid[e] them with even lower cost group insurance, that burden must be held unmet.

In *Louisiana Credit Union League*, the Fifth Circuit likewise held that "the 'profit motive' standard is the proper one to be applied," ruling that, "[i]f the organization has as its motive the production of income, the challenged activity constitutes a trade or business under section 513(c)" (693 F.2d at 532). The record in that case indicated that the association had "extensive involvement in insurance * * * activities" and that it engaged in them "primarily because [they] produced revenue necessary to finance [its] operations" (*id.* at 532-533). These facts, the Fifth Circuit explained, showed the existence of a "trade or business" (*id.* at 533):

> [The association] did everything short of actually selling the insurance * * * itself: it selected the companies whose products and services would be endorsed, actively marketed and promoted those products and services to [its] member[s] * * *, and performed the day-to-day administrative tasks essential to the insurance * * * operations. More comprehensive involvement would be difficult to imagine. As

> reflected by the [association's] receipts for the years in issue, [it] was amply rewarded for its efforts—its activities were highly profitable, and those profits were increasing. We agree with the district court that the [association] had the 'profit motive' for its insurance * * * activities necessary to a finding of a trade or business * * *.

In *Professional Insurance Agents*, the Sixth Circuit explicitly followed these decisions and held that Section 513(c) "requires us to examine the exempt organization's underlying reasons for engaging in the questioned activity. If it has as its motive the production of income, the activity constitutes a trade or business" (726 F.2d at 1102). The court of appeals examined the marketing, administrative, and promotional activities that the association had undertaken to support the insurance program, and concluded that it had "engaged in extensive activity over a substantial period of time with intent to earn a profit" (*ibid.*). The court accordingly held that the association's "motive for offering the insurance policies at issue * * * was one of profit sufficient to support a finding that the premiums it received were from a trade or business" (*ibid.*).

2. In the instant case, the Endowment, like the three associations just discussed, serves as a middleman between its members and commercial vendors of insurance. In that capacity, its full-time staff of 40 performs promotional and administrative services substantially identical to those performed by the employees of those associations. See Pet. 3-4; Pet. App. 2a-3a, 27a; C.A. App. 139, 141-142, 811, 1248-1268. Indeed, respondent does not dispute our contention that its employees discharge during their working day the same types of tasks whose aggregation the Fourth, Fifth, and Sixth Circuits have held to constitute a "trade or business." See Br. in Opp. 12-14.

The Endowment likewise derives substantial revenues from its insurance operations. It causes the underwriters to "set the premiums as high as possible without discouraging participation," charging premiums "at a level competitive with other insurance on the market," so that

the Endowment in turn can "benefit from the high dividends" that result from its members' favorable claims experience (Pet. App. 4a). The Endowment thus contrives, just as the associations in the Fourth, Fifth, and Sixth Circuit cases contrived, to earn large rebates from the insurance underwriters, rebates which it refuses to distribute to its members. Contrary to respondent's contention (Br. in Opp. 4-5, 12-14), it is immaterial who—as between the underwriters and the members—should be regarded as the ultimate "source" of these insurance revenues. A middleman may be paid by the buyer, the seller, or both; in determining whether he is engaged in a "trade or business," it is irrelevant who remunerates him. The point is that the Endowment performed a variety of insurance-related services, the result of which was that it received, through a combination of premium payments from its members and policy dividends from its underwriters, a substantial volume of insurance-related income.

The only question, therefore, is whether the Endowment's insurance-related income was derived from "a trade or business." Three other circuits have held that, in determining whether a tax-exempt organization's insurance activities amount to a trade or business, "the court must look to see whether [it] has engaged in extensive activity over a substantial period of time with intent to earn a profit" (*Professional Insurance Agents*, 726 F.2d at 1102). The court of appeals below did not dispute that the Endowment's insurance operation—which has been conducted since 1955 and involves the administration of billions of dollars in policies held by 57,000 members—amounts to "extensive activity over a substantial period of time." The Federal Circuit, however, refused to find dispositive "the fact that the Endowment * * * set out to make as much 'profit' as possible" (Pet. App. 11a). "Unlike what some other courts may do," the Federal Circuit said, "this court does not find 'profits,' or the maximization of revenue, to be the controlling basis for a determination of whether the unrelated business tax provisions apply" (*ibid.*). In a foot-

note to that sentence, the court explicity refused to adopt the Fifth Circuit's conflicting legal analysis in *Louisiana Credit Union League*, a case that the Federal Circuit interpreted to stand for the proposition that the "intent to earn a profit [is] determinative." Pet. App. 11a n.4 (citing 693 F.2d at 532).

3. In its brief (Br. in Opp. 15-16), the Endowment accepts our contention (Pet. 14-15) that the cases discussed above cannot be distinguished on the ground principally adduced by the courts below—*i.e.*, that the associations marketing the insurance there were tax-exempt under Section 501(c)(6), whereas the Endowment is tax-exempt under Section 501(c)(3). See Pet. App. 10a, 25a-26a. The Endowment concedes "that a section 501(c)(3) organization and a section 501(c)(6) organization [should not] be treated differently for purposes of section 513 if they are operating in the same manner" (Br. in Opp. 15-16 (emphasis omitted)). The Endowment also appears to agree that its insurance operations entail the performance of substantially the same activities as were performed by those other associations; at least it makes no effort to distinguish the cases on that ground (see Br. in Opp. 12-14). And the Endowment likewise seems to agree that, in running the insurance operation, it was "engaged in extensive activity over a substantial period of time with intent to earn a profit" (*Louisiana Credit Union League*, 693 F.2d at 532).

Respondent nevertheless seeks to distinguish the cases we cite on the basis of what it calls "the unique facts of this case" (Br. in Opp. 12). In respondent's view, it was clear that those other associations were engaged in a "trade or business," since their insurance activities were "carried on for the production of income from the sale of goods or the performance of services" (I.R.C. § 513(c)). According to respondent, however, the Claims Court here made "findings of fact" (Br. in Opp. 9) that the Endowment's revenues were not derived "from the sale of goods or the performance of services" (I.R.C. § 513(c)), but rather "were attributable to the generous decision of Endowment members to support [its] charitable fundraising effort" (Br. in Opp. 9). The Claims Court assertedly based this finding of fact on subsidiary findings that the Endowment's insurance program was devised "as a means for charitable fundraising" (Br. in Opp. 4), that its members "considered the insurance program a fundraising activity" (*id.* at 7 n.7), that the insurance revenues reflected "the 'intent of the members to support [its] charitable activities'" (*id.* at 11), and that its members knew that part of their premiums "would go to charity" (*id.* at 8).

Contrary to respondent's contention, the Claims Court was not "finding facts" when it characterized the Endowment's insurance activities as "charitable fundraising." Rather, it was engaging in a labeling process that is not responsive to the question presented. In determining whether the Endowment's insurance activities constitute a "trade or business," it is legally irrelevant that it describes those activities as "charitable fundraising," since *all* of a charity's money-raising activities can be so described. One could well have styled NYU's sale of spaghetti through its macaroni factory as "charitable fundraising," since the profits went to finance NYU's educational activities. See *C.F. Mueller Co.* v. *Commissioner*, 190 F.2d 120 (3d Cir. 1951). Indeed, the Fifth and Sixth Circuits have observed that the insurance operations of a tax-exempt organization "are basically a fund raising activity," but have held that those activities are nevertheless an unrelated "trade or business." *Professional Insurance Agents*, 726 F.2d at 1104; *Louisiana Credit Union League*, 693 F.2d at 537. It is likewise irrelevant that the Endowment's members wanted to aid its charitable endeavors and knew that part of their premiums would "go to charity." People who purchased spaghetti from NYU's macaroni company rather than from its competitors may well have known that part of the purchase price would "go to charity," and may well have been motivated by the thought that NYU would make good use of the profits thus derived. But Congress dictated the irrelevance of these facts by enacting the unrelated business income tax in 1950, and

by amending it in 1969 to make clear that "the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services" (I.R.C. § 513(c)).

Equally irrelevant in determining whether respondent was engaged in a "trade or business" are the facts that the Endowment "set premiums at levels significantly higher than necessary" to cover its costs (Br. in Opp. 6), and that its "receipts have far exceeded the value of any services which might have performed in the course of its administration of the plan" (Pet. App. 9a). To begin with, respondent's most valuable services were not the mechanical tasks of administering the plan, but its ability to exploit its unique access to a pool of better-than-average insurance risks by endorsing, marketing, and promoting the program. The group insurance plans involved in the Fourth, Fifth, and Sixth Circuit cases for similar reasons were also "highly profitable" (*e.g.*, *Louisiana Credit Union League*, 693 F.2d at 533). The association in *Professional Insurance Agents*, for example, incurred expenses of only $12,000 to generate income of $176,000 from its insurance plans. Noting the wide differential between the one figure and the other, the Tax Court reasoned that the association "was being compensated not so much for the administrative services it performed as it was for endorsing the insurance company's product and providing a direct pipeline to its membership." 78 T.C. 246, 262 (1982).

More fundamentally, respondent's approach confuses the perspective of the seller with that of the retail buyer. Middlemen invariably mark up the goods or services they sell; that is how they make money. The principal constraint on a middleman's ability to make profits is the market; if he seeks too high a mark-up above his costs, customers will buy elsewhere. The only relevant factual question, therefore, was whether the retail price that the Endowment charged for participation in its group insurance plan was within the range of prices for comparable insurance in the retail marketplace generally. A trial was held to answer this question, and the Claims

Court found that the Endowment's "gross premiums were set with reference to the rates for other insurance products available in the market" (Pet. App. 29a). The Federal Circuit affirmed that finding, noting that the Endowment "set the premium at a level competitive with other insurance on the market" (*id.* at 4a). These factual findings, which are really the only important factual findings in the case, mean that the retail price paid by the Endowment's members was equal to the fair market value of the insurance they purchased, so that they have no claim to any charitable contribution deduction. These factual findings also show that the Endowment's insurance operation was "conducted in a competitive profit-seeking manner" (*Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 171), and thus constitutes a "trade or business" under the "profit motive" test adopted by the Fourth, Fifth, and Sixth Circuits.

4. The Endowment asserts (Br. in Opp. 17), as did the Claims Court (Pet. App. 46a), that "for 21 years the Internal Revenue Service took the position that ABE's operation of the insurance program was not taxable." This assertion is incorrect. The Endowment's insurance operation, begun in 1955, first came under audit in the late 1960s. In 1972, during one of these audits, the IRS National Office issued technical advice to the Chicago District Director in which it determined that the unrelated business income tax should not be asserted against the Endowment's insurance profits for its 1965-1967 tax years. In 1973, the National Office revised and reissued this unpublished technical advice memorandum to make the rationale more restrictive. Upon further reflection, the IRS in 1976 withdrew its favorable ruling altogether and advised the Endowment no longer to rely on it (C.A. 854).

This course of administrative action adds nothing to the Endowment's case. The short-lived favorable rulings of 1972 and 1973 related to tax years (1965-1967) that preceded the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 *et seq.* As explained in greater detail in our brief in *United States* v. *American College of*

Physicians (84-1737 U.S. Br. at 22-26), the 1969 Act included the first statutory definition of the phrase "trade or business" for purposes of the unrelated business income tax; that definition is now codified in Section 513(c). In determining not to assert the tax against the Endowment for pre-1969 tax years, the IRS was cognizant of two court decisions (*Oklahoma Cattlemen's Ass'n* v. *United States*, 310 F. Supp. 320 (W.D. Okla. 1969); *San Antonio District Dental Society* v. *United States*, 340 F. Supp. 11 (W.D. Tex. 1972)), likewise involving pre-1969 tax years, which had characterized the definition of "trade or business" as a "problem" and noted that the Code prior to 1969 provided no helpful guidance. Moreover, the definition of "trade or business" set forth in the Treasury Regulations, which the 1969 Act codified, did not appear until after the close of the Endowment's 1967 tax year. See Treas. Reg. § 1.513-1; 32 Fed. Reg. 17657 (1967). The Commissioner's determination not to assert the unrelated business income tax against the Endowment for its 1965-1967 tax years thus has little if any bearing on whether the tax applies under Section 513(c) as it now stands. At all events, this Court has regularly held that the Commissioner is free to change his legal position if he determines that his initial conclusion was in error. *Automobile Club* v. *Commissioner*, 353 U.S. 180 (1957); *Dixon* v. *United States*, 381 U.S. 68 (1965).

For these reasons and the reasons set forth in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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